

Frequently Asked Questions regarding *Order Adopting Consideration Given to Credit Exposure Arising from Derivative and Securities Financing Transactions*.

1. What is the purpose of the Department Order of January 21, 2013?

Answer: The Department Order allows banks to enter into derivative transactions. Congress, through the Dodd Frank 2010 Act, mandated that statutory changes be made or banks would be prohibited from entering into derivative transactions after January 21, 2013. The Order determines the manner and extent to which credit exposure from derivative transactions is taken into account with regard to lending limits.

2. What is a derivative?

Answer: A derivative is a risk shifting device that utilizes a contract between two parties that specifies conditions (especially the dates, resulting values of the underlying variables, and notional amounts) under which payments are to be made between the parties. Derivatives can be useful tools for banks to effectively manage risk and on a very broad measure are described as either credit or non-credit derivatives.

3. What is a credit derivative?

Answer: Credit derivatives are contracts with which banks buy or sell credit protection against loss on a third-party entity. Common types of credit derivatives include credit default swaps and total return swaps.

4. What is a non-credit derivative?

Answer: Non-credit derivatives are contracts regarding performance at a point in time unrelated to specific credit risk, such as, but not limited to, interest rates or future delivery. Non-credit derivative transactions include, but are not limited to, forwards, futures, options, caps, or floors.

5. Is the Department's Order on derivatives applicable to every bank?

Answer: The Department's Order is applicable to any bank that enters into derivative or security financing transactions. Please refer to the flow chart found at the end of this document for more detail.

6. Can all banks participate in derivative activities?

Answer: A bank may participate in derivative activities if it is well-capitalized as defined in prompt corrective action rules. A bank not well-capitalized may participate in derivative activities with the prior written approval of the Director. For example, a bank that is involved in the origination and sale of one-to-four family real estate loans would have to discontinue such derivative activity if it became less than well-capitalized unless it obtained the prior written approval of the Director.

7. Is a transaction which enables the flow of individual bank-originated one-to-four family real estate loans for sale into the secondary market a derivative?

Answer: If the transaction includes a delivery guarantee, the transaction is a derivative. However, the credit exposure arising from such derivative transaction is not subject to lending limits.

8. How do derivatives impact the calculation of the credit exposure of an entity in regard to compliance with a bank's lending limit?

Answer: The credit exposure resulting from derivative transactions is added to all other credit exposures arising from a customer's or counterparty's promise to perform, such as other loans, bank-issued credit cards, and overdrafts, in determining compliance with the bank's legal lending limit.

9. Are derivatives useful to a bank?

Answer: Derivatives can be effective at managing risk. Banks can gain certainty by locking in an interest rate or use swaps as useful tools to

manage risk. However, derivatives can be risky if sound risk management policies, procedures, and goals are not in place. If used in a speculative manner, derivatives increase risk.

10. What are the typical types of derivatives used by banks?

Answer: Interest rate swaps are the most common derivative transactions engaged in by banks. Interest rate swaps provide banks flexibility in managing their interest rate risk, but drastic interest rate movements can still result in an institution suffering substantial losses. Historically, interest rate swaps represent approximately 80% of all derivatives contracts.

11. Can a bank switch between methods used to calculate credit risk?

Answer: With the prior written approval of the Director, a bank may change its method of calculating counterparty credit exposure.

12. When is the credit exposure assigned to a loan customer versus a counterparty for lending limit purposes?

Answer: The entity to which the credit exposure gets assigned for lending limit purposes will depend on the parties involved in the derivative contract. Balance sheet hedges to either convert assets/liabilities from fixed to variable, or variable to fixed, are typically achieved through a swap with a separate counterparty. If these transactions do not directly involve the borrower as a party to the transaction, the calculated exposure for the derivative is allocated to the counterparty for lending limit purposes. However, a bank may enter into a loan with a borrower and then enter into a swap with the borrower to convert to the borrower's payment (from fixed to variable or variable to fixed), and an opposite swap with a counterparty to convert the bank's payment. In this case, there would be credit exposure on the swap with the borrower, which would be added to the borrower's total loans for lending limit purposes, and there would be credit exposure on the swap with the counterparty that would be assigned to the counterparty.

13. In regard to a bank's lending limit, should a bank be monitoring its credit exposure from derivatives transactions any differently than it monitors its credit exposure to an individual loan customer?

Answer: The degree to which management monitors the credit exposure from derivative transactions in regard to the bank's lending limit will depend on the amount of the exposure in relation to the lending limit. For example, loans at or near the lending limit require close monitoring by management so additional loan advances or extension of credit through overdrafts do not put the credit over the lending limit. For loans substantially under a bank's lending limit, little or no monitoring for lending limit purpose is probably needed. The same is true for credit exposure from derivative transactions. For banks with large and/or numerous derivative transactions with one entity, the close monitoring of the total exposure and changes in that exposure in relation to the lending limit will be warranted. The manner as to how this exposure is monitored would be up to each bank.

14. Does the word "credit" have different meanings within the Department's Order?

Answer: The Order addresses eligible credit derivatives, which include non-credit and credit derivatives, and the calculation of credit exposure for both. While there is a significant difference in the calculation of the credit exposure of these two categories, a bank has credit exposure to the parties it contracts with in either type of derivative.

15. How is the credit exposure calculated for an interest rate swap or cap?

Answer: As an example, a bank enters into a \$1,000,000, 5-year, interest rate swap with either a loan customer or a separate counterparty. Under the Conversion Factor Matrix Method, the potential future credit factor for the swap is 6% according to Table 1 in Appendix C of the Order. The bank would have exposure of \$60,000 ($\$1,000,000 \times 6\%$) from day one throughout the life of this swap. The same calculation would be done for an interest rate cap with the same terms since both are interest rate transactions.

For an example under the Remaining Maturity Factor Method, a bank enters into the same 5-year, interest rate swap, with either a loan customer or a counterparty, having a notional value of \$1,000,000 and a current mark-to-market (MTM) value of zero at execution. On the date of execution, the bank's exposure is \$75,000 ($\$0 + (\$1,000,000 \times 5 \times 1.5\%)$). The calculation of the credit exposure under this method equals the sum of the current MTM of the derivative transaction added to the product of the notional amount of transaction, the remaining years of the transaction, and the multiplicative factor determined by reference to Table 2 in Appendix C of the Order. The credit exposure cannot be less than zero even though the calculation might be negative due to a negative current MTM. Assume the bank has other loan or derivative activity in year 3, at which time the MTM of the swap is \$10,000. The bank's lending limit exposure of the swap would be \$40,000 ($\$10,000 + (\$1,000,000 \times 2 \times 1.5\%)$). If the MTM of the swap was a negative \$10,000 in year 3, the bank's lending limit exposure for the swap is \$20,000 ($-\$10,000 + (\$1,000,000 \times 2 \times 1.5\%)$). If the MTM of the swap in year 3 had been a negative \$40,000, the bank lending limit exposure for the swap is zero since the calculated exposure equaled a negative \$10,000 ($-\$40,000 + (\$1,000,000 \times 2 \times 1.5\%)$). Zero is the floor for the calculated exposure.

The calculated lending limit exposure of the swap would be added to a loan customer's total borrowings for lending limit purposes if the swap agreement was entered into by the bank and the customer. However, if the contract was entered into by the bank and a separate counterparty, the calculated exposure would be assigned to the counterparty, along with the calculated exposure on any other swaps or derivatives entered into with that particular counterparty.

16. Is the exposure to government-sponsored entities unlimited?

Answer: Nebraska law makes exclusions for lending limit consideration when the borrower or counter party is backed by the full faith and credit of the US Government.

Does the Department's Order regarding derivative transactions influence my bank's operations?

Does bank report derivative activity on the call report?

NO

Order addresses methods of calculating credit default risk and changing market risk relative to bank lending limits. Only those banks with derivatives are impacted.

YES

1-4 family loans

Contracts for the flow of individual bank-originated 1-4 family real estate loans into the secondary market are not held to a lending limit.

The next step is based upon derivative parties and contracts

Credit Derivatives

Counterparty is influenced by the trigger event of a loan customer (reference entity). Counterparty and reference entity credit exposure must each be calculated.

1. A bank shall calculate counterparty credit exposure from the credit derivative by adding the net notional value of all protection **purchased** from the counterparty.

2. The bank shall calculate the credit exposure to a reference entity arising from credit derivatives entered by the bank by adding the notional value of all protection **sold** on the reference entity.

3. The bank may reduce its exposure to a reference entity by the amount of any eligible credit derivative purchased on that reference entity from an eligible protection provider.

Non-Credit Derivatives

Calculate credit exposure to a counterparty using one of the following methods.

1. Conversion Factor Matrix
2. Remaining Maturity

Securities Financing Transactions

Securities transactions include:

1. Repurchase Agreements
2. Securities Lending
3. Reverse Repurchase Agreements
4. Securities Borrowing